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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 600

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MOUNTAIN PRODUCERS CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 38–45) is reported in 34 B. T. A. 409. The opinion of the Circuit Court of Appeals (R. 152–160) is reported in 92 F. (2d) 78.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 26, 1937 (R. 160). The petition for a writ of certiorari was filed November 26, 1937, and was granted January 3, 1938 (R. 162). The jurisdiction of this Court rests on Section

240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the income which the respondent's affiliate received under a trust agreement with the owner of an oil and gas lease from the State of Wyoming is exempt from Federal income tax.

2. Whether the production expenses paid by the purchaser of all the oil produced from the oil lands of the respondent's affiliate are gross income from the property of the respondent's affiliate in addition to the cash price paid for the oil.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra,* pp. 56–60.

STATEMENT

The facts as stipulated (R. 53–145) and as found by the Board of Tax Appeals (R. 33–38) are substantially as follows:

During the calendar year 1925, the tax year in question, the respondent, a Delaware corporation, owned all the capital stock of, and was thus affiliated with, Wyoming Associated Oil Corporation, a Delaware corporation, hereinafter called Wyoming Associated. The respondent filed a consolidated income tax return for that year upon which the deficiency involved in this case was determined (R. 33).

In 1910 one Fitzhugh obtained a lease dated January 4, 1910 (R. 141–144), from the State of Wyoming, covering a section of school land. He held this lease, among others, for the benefit of a mining partnership of which he was a member (R. 54). In 1911 Fitzhugh and one other partner transferred their undivided interests to the Midwest Oil Company, hereinafter called Midwest (R. 54).

The State leased this school land for five year terms and on December 31, 1914, the Fitzhugh lease expired. Thereafter Midwest made successive leases commencing on January 1, 1914, October 1, 1919, and October 1, 1924. None of the leases contained an option or privilege of renewal (R. 125–144). Each lease provided that it could not be assigned without the consent and approval of the State (R. 129, 135, 140, 143). The 1924 lease, applicable to the tax year in question, 1925, provided that a royalty of 65 per cent. of the oil and gas produced should be paid to the State (R. 125–126).

After a series of transfers of their interests by the other partners of Fitzhugh and their successors, Wyoming Associated, immediately after its organization in 1919, received these interests for its capital stock (R. 54–58). It received at that time various deeds, assignments, and conveyances covering certain placer mining claims, patented lands, and interests in oil and gas leases in the Salt Creek Oil Field in Natrona County, Wyoming (R. 33). Pursuant to the Oil and Gas Leasing Act of Congress, approved on February 25, 1920, Wyoming Associ-

ated in 1920 and 1921 exchanged its placer mining claims for Government leases (R. 33) and on or about February 1, 1923, exchanged certain lands and leases for similar property of Midwest and of Wyoming Oil Fields Company in the Salt Creek Oil Field for the purpose of consolidating leaseholds into more compact blocks to decrease offset drilling (R. 58–59).

On February 1, 1923, Wyoming Associated and Midwest executed a "Declaration of Trust" (R. 111–112), which recited that the Midwest was owner of the five year lease of school land from the State dated October 1, 1919, covering all of the one section of school land in Natrona County granted to the State by the United States. The instrument declared that Midwest held an undivided fifty per cent. interest in the lease, and in the renewals and extensions thereof and in the benefits and net proceeds to be realized therefrom, for the use and benefit of Wyoming Associated, which agreed to share the obligations of the lease. The lease here involved is the one dated April 19, 1923, which ran for five years from October 1, 1924, when the former lease expired. It also covered all of the same section of school land. The record does not disclose any assignment of the lease, either with or without the consent of the State which was required by the terms of the lease.

The State received its agreed royalty of 65 per cent. of the oil produced in kind in 1925 and the

proceeds of the sale of the remaining oil were divided equally between Wyoming Associated and Midwest (R. 35).

On the same day as the "Declaration of Trust," February 1, 1923, Wyoming Associated, Midwest, and Wyoming Oil Fields Company entered into a contract (R. 113–118) with the Midwest Refining Company, hereinafter called the Refining Company, which referred to the declaration of trust and provided that the Refining Company agreed to buy and the other three companies agreed to sell, until January 1, 1934, all the oil produced from the property in the Salt Creek Oil Field owned or leased jointly by them (except oil used for drilling, domestic or production purposes) upon a sliding scale of prices based on the average price received by the Refining Company for gasoline and kerosene. The three companies agreed to give the Refining Company free use of all equipment on the property and of all oil and gas reasonably necessary for production operations (R. 115). The Refining Company agreed "as part of the price for oil purchased" to conduct all development and production operations upon the said lands (R. 115). The Refining Company agreed to take delivery of the oil purchased at the outlet gates of the measuring tanks located at or near the wells on the property and also agreed that the oil royalties in kind to which some of the tracts of land were subjected were not included in the purchase agreement and

would be delivered by the Refining Company to the royalty owners (R. 115–116).[1]

The consolidated return for 1925 filed by the respondent and its affiliate, Wyoming Associated, was on the accrual basis and did not include as income any amount expended by the Refining Company under the two production contracts dated February 1, 1923 (R. 37). These expenses were not entered on the books of the respondent or of Wyoming Associated as income. The return included in gross income the net prices actually received under the production contracts. The return computed depletion based on gross income by taking 27½ per cent. of the market price of oil in the field at the date of production (R. 37). The tax of $271,342.32 disclosed by the return was paid in five installments in 1926 (R. 37).

In a notice dated March 14, 1929 (R. 6–9), the Commissioner notified the respondent of a deficiency of $90,642.87 determined for the most part by including in income the amount of $185,438.83 received under the declaration of trust of Midwest and by reducing the depletion allowance to a percentage of the cash received for oil produced.

Before the Board of Tax Appeals the respondent urged that the income received under the declara-

[1] A separate contract containing similar provisions for the oil lands in the Salt Creek Field owned or leased solely by Wyoming Associated was entered into between Wyoming Associated and the Refining Company for the same period of time (R. 118–123).

tion of trust was immune from tax and that the gross income on which the percentage depletion should be computed with respect to the other oil properties should be (1) either the market value of the oil produced, or (2) the amount of $4,606,535.70 received under the contracts for oil purchased plus the operating expenses of the Refining Company in the amount of $2,816,520.04 (R. 22, 32, 145). It also urged that in lieu of percentage depletion the Commissioner should have allowed depletion based upon cost (R. 22, 32).

The Board of Tax Appeals held that (1) gross income of Wyoming Associated for purposes of computing percentage depletion did not include expenses of the Refining Company; (2) income under the trust agreement from the state school land is not exempt from Federal income taxation; and (3) depletion based on gross income, excluding expenses of Refining Company, or on cost, whichever was greater, should be recomputed (R. 38–45). Thereupon the deficiency was reduced to $67,509.13, apparently for the reason that cost depletion of some leases exceeded percentage depletion (R. 45).

The Circuit Court of Appeals reversed the Board on both issues and held that respondent's gross income for calculation of depletion included the operating expenses of the Refining Company and that the income from the school land lease was exempt. Circuit Judge Phillips dissented with an opinion on the second issue (R. 151–160).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the income received by Wyoming Associated under the trust agreement with the Midwest Oil Company from the lease of state school lands is exempt from Federal income taxes.

2. In holding that gross income of Wyoming Associated for the computation of percentage depletion should include not only the cash received for oil sold but also the expenses of the purchaser incurred in the production of the oil pursuant to the purchase agreements.

SUMMARY OF ARGUMENT

I

A. The respondent's affiliate is not exempt from taxation under the rule of *Gillespie* v. *Oklahoma,* 257 U. S. 501, and *Burnet* v. *Coronado Oil & Gas Co.,* 285 U. S. 393. These cases confer immunity on the *lessee* of government lands. It is plain that Wyoming Associated was not a lessee of the lands in question. The fact that the Midwest Oil Company declared that it held 50 per cent. of the lease and its net proceeds in trust for Wyoming Associated did not give rise to any rights against or obligations to the State, nor was any income received by Wyoming Associated from the State or from the operation by it of state property. To subject Wyoming Associated to Federal taxation would in no manner interfere with the functions of the State. Its status was essentially equivalent

to the one who sells goods to a government contractor, *Trinityfarm Co.* v. *Grosjean,* 291 U. S. 466, or to the lessee who seeks to escape a property tax after the royalty to the government has been paid, *Indian Territory Oil Co.* v. *Board,* 288 U. S. 325.

B. If, notwithstanding these considerations, the Court should think the rule of the *Gillespie* and *Coronado* cases applicable here, it must then consider whether these cases can be reconciled with subsequent decisions of this Court.

Group No. 1 Oil Corp. v. *Bass,* 283 U. S. 279, and *Burnet* v. *A. T. Jergins Trust,* 288 U. S. 508, have refused to follow the *Gillespie* and *Coronado* cases; and the distinctions made seem not to be related to the basis of the rule of intergovernmental tax immunity. Each of the reasons advanced in the *Gillespie* and *Coronado* cases for granting the exemption has expressly been rejected by the Court. Moreover, these decisions seem contradicted by the principle of *Indian Territory Oil Co.* v. *Board,* 288 U. S. 325, holding that immunity to property taxation vanishes after the state royalty has been paid.

Not only are these cases repudiated by subsequent decisions, but they seem contrary to the basic reasons for granting immunity. The lessee of government lands is not serving the sovereign but seeking a private profit. He realizes this profit in a private transaction. To exempt him from a non-discriminatory tax is to give him a special ad-

vantage. Even if this advantage should be reflected in a special advantage to the government lessor, this favored position is not necessary to maintain the sovereign independence of the Nation or the States.

II

A. The production operations of the Refining Company were not gross income of Wyoming Associated. These operations were conducted by the Refining Company for its own benefit and to obtain oil at the cash contract price. Wyoming Associated never treated the production operations as its income either in its books or in the income tax return. Wyoming Associated might have obtained a larger cash price for the oil and, therefore, a larger gross income if it had performed and paid for the production operations. But it did not choose to engage in the business of producing oil. The fact that it might have done business in another manner is no reason for constructing an artificial gross income by adding to the price actually received a value of production operations by the Refining Company for its own benefit. Congress did not intend that "gross income from the property" for percentage depletion should be determined in such a manner. The optional method of cost depletion is available to the respondent if the cash gross income received is not considered sufficient.

B. Even if the Refining Company's production operations have some value to Wyoming Associated which may be considered in computing its gross income, the total field operating expense of the Refining Company is not a correct measure of the value of the operations to Wyoming Associated. The operations were performed also for the benefit of the Refining Company and part of their total value may be allocable to the Refining Company. A part of the operations may have produced no oil and, therefore, may have been a loss and valueless to Wyoming Associated.

C. The Government contends that the sole depletable gross income was the cash price received for the oil and does not contend that the Refining Company has a depletable interest. It is to be noted, however, that the respondent's contention would leave no depletable interest for the Refining Company.

ARGUMENT

I

THE RESPONDENT'S AFFILIATE IS NOT EXEMPT FROM FEDERAL INCOME TAX ON THE SHARE OF INCOME RECEIVED FROM THE STATE SCHOOL LEASE UNDER ITS AGREEMENT OF TRUST WITH THE MIDWEST OIL COMPANY

A. *Respondent's Affiliate was not a Lessee of the State School Lands and so is not Exempt from Federal Taxation*

In 1910 one Fitzhugh entered into an oil lease, covering the school land in question, with the State

of Wyoming (R. 141). He held this lease, among others, for the benefit of a partnership of which he was a member; the other members similarly held other leases in their own names. In 1911 Fitzhugh and one other partner transferred their undivided interests to Midwest (R. 54). After a series of transfers by the other partners (R. 54–57), Wyoming Associated was organized on July 11, 1919, to hold and develop a variety of interests in different oil leases, including an interest, corresponding to the interest of the other members of the Fitzhugh partnership, in a lease of this school land (R. 57–58). On October 1, 1923, Midwest and Wyoming Associated entered into a "Declaration of Trust" under which Midwest held an undivided one-half interest in the benefits and net proceeds of the state lease, and its extensions and renewals, for the benefit of Wyoming Associated (R. 111).

The State leased this school land for five year terms. The Fitzhugh lease ran to December 31, 1914. Thereafter successive leases were made to Midwest commencing, respectively, on January 1, 1914, October 1, 1919, and October 1, 1924. None of the leases contained an option or privilege of renewal (R. 125, 131, 136, 141). Each lease contained a provision that it could not be assigned without the consent and approval of the State (R. 129, 135, 140, 143). The 1924 lease, applicable to the taxable year in question, 1925, provided that a royalty of 65 per cent. of the oil and gas produced should be paid to the State in kind (R. 125–126).

On February 1, 1923, Midwest, Wyoming Associated, and another producing company entered into a contract (R. 113–118) with the Refining Company, covering four leases, including the state lease. Under this contract the Refining Company agreed to produce the oil, to deliver to the lessors any royalties to be paid in kind, and to purchase the remainder at the outlet gates of the measuring tanks at a sliding scale of prices. The contract was to run until January 1, 1934 (R. 113–118). The Refining Company delivered the royalty oil to the State, and paid one-half of the purchase price of the remainder to Midwest and one-half to Wyoming Associated. A representative to check the production was kept at the field by Wyoming Associated (R. 35).

The court below held the income of Wyoming Associated to be exempt from federal taxation under the rule of *Gillespie* v. *Oklahoma*, 257 U. S. 501, and *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393. It is unnecessary to consider whether these decisions can be reconciled with other and later decisions of this Court, notably *James* v. *Dravo Contracting Co.*, No. 3, October Term, 1937, because, even under the *Gillespie* and *Coronado* cases, Wyoming Associated is not exempt from taxation.

1. In the *Gillespie* case this Court stated that "It is agreed that *the lessee* was an instrumentality used by the United States in carrying out duties to the Indians that it had assumed, and that the

only question in the case is whether he is liable to" the State income tax (257 U. S. at 504; italics added). In the *Coronado* case the Court held that "the lease to the respondent was an instrumentality of the State * * *. To tax *the income of the lessee* arising therefrom would amount to an imposition upon the lease itself" (285 U. S. at 400–401; italics added). The decision in each case confines the exemption to the lessee of the state lands.

It must be remembered that the rule of the *Gillespie* and *Coronado* cases is not one to be given a wide and general application, but, on the contrary, is one to be applied only within a very narrow field. Three Justices dissented in the *Gillespie* case; four dissented in the *Coronado* case. In the latter case the majority of the Court declared (285 U. S. at 398):

> We are disposed to apply the doctrine of *Gillespie* v. *Oklahoma* strictly and only in circumstances closely analogous to those which it disclosed.

This statement was repeated in *Burnet* v. *A. T. Jergins Trust,* 288 U. S. 508, 516. It seems clear that the case at bar is not closely analogous to the facts of the *Gillespie* and *Coronado* cases. Neither the reason underlying these decisions nor any language found in the opinions warrants their extension to confer immunity from taxation upon persons who derive their income, not from the State and not from any lease entered into with the State by the

taxpayer, but only by virtue of a contractual arrangement with the lessee of the state lands.

2. It seems plain that Wyoming Associated was not a lessee of state lands and is not entitled to share in any immunity from taxation which may be granted to such lessees.

a. The state lease was made with Midwest, and contained a provision that it could not be assigned without the consent of the State. The record contains no evidence that the consent of the State to an assignment was either sought or obtained. Wyoming Associated has a claim to the oil or the proceeds only by virtue of its agreement with Midwest. The State has given Wyoming Associated no rights, and Wyoming Associated has assumed no obligations toward the State. They are, so far at least as this lease is concerned, strangers to one another. The court below, in granting exemption from federal income taxation to such a corporation has made a startling extension of the doctrine of intergovernmental tax immunity.

It is evident that there can be no claim that Wyoming Associated was itself an instrumentality of the State. Its only claim to tax immunity rests on the "Declaration of Trust" made by the Midwest Oil Company, to the effect "that it holds an undivided fifty per cent. (50%) interest in said lease and the benefits and net proceeds to be realized therefrom." The preceding paragraph of the trust instrument states the beneficial interest of Wyoming Associated as relating only to "the benefits and

net proceeds realized by the Midwest Oil Company." Wyoming Associated was to "share all of the burdens and obligations hereafter accruing under said lease" (R. 111–112).

It is unnecessary to decide whether this instrument creates a trust interest in the lease or only in the net proceeds.[2] In neither case does Wyoming Associated derive its income from the State or from the state oil land. The income is paid over only by virtue of contractual arrangements with the lessee of the state land. Immunity from taxation is not to be controlled by the attorney's choice of words in the instrument by which the lessee promises to share its net income. The important thing is that Wyoming Associated was not a lessee of the state lands, nor was it an assignee of the lease. Its rights and duties ran only to the Midwest Oil Company. As Judge Phillips, dissenting below, said (R. 160), Wyoming Associated "had no direct con-

[2] It should, however, be noted that Midwest and Wyoming Associated viewed the "Declaration of Trust" as something different from a joint ownership of the lease. The agreement of February 1, 1923, made by Midwest, Wyoming Associated, and another producer with the Refining Company, covered four leases. Three of them were described as "owned an undivided 50 per cent" by Wyoming Associated and "an undivided 50 per cent by" Midwest or the other producer. The state lease, however, was not so described, but was said to be "held in trust by The Midwest Oil Company for the benefit of" Midwest "to the extent of an undivided 50 per cent interest and for the benefit of" Wyoming Associated "to the extent of an undivided 50 per cent. interest" (R. 113).

tractual relation with the State. Its right under the contracts with Midwest was to share in the net proceeds of the lease. * * * the incidence of the tax is so remote in its influence or effect upon the exercise by the State of its governmental functions as to have no substantial adverse effect upon them."

The court below based its decision upon the proposition (R. 156):

> In the case at bar we find the lessee and the taxpayer bound together by a trust agreement entered into before the lease by the State was made by which they were to have equal rights in the lease itself and the net proceeds realized from it in whichever name of the parties the lease or any renewal or extension should stand. In substance and effect the Wyoming Associated was as much a lessee of the lands as was the Midwest Oil Company, the lessee in name.

The court thus seems to attach significance to the fact that the "declaration of trust" was entered into prior to the time that Midwest leased the land from the State. Whatever might be the status of Wyoming Associated had it been a joint-lessee, the fact remains that it was not a lessee of any nature. It purchased the right to share in the profits realized by Midwest by surrendering more or less similar interests which it or its predecessors had possessed since the original Fitzhugh lease. But the fact that the interest of Wyoming Associated was one of long standing does not serve to establish a

relationship with the State. Just as fully as though the interest had been purchased after the lease had been made, Wyoming Associated derived its income only by virtue of its contract with Midwest.

The fact that the declaration of trust agreed, as between the parties, that Wyoming Associated was to hold a one-half interest in trust for Midwest Oil Company *if* any "renewal or extensions" of the lease were made in the name of Wyoming Associated, or in their joint names (R. 112), is immaterial. The contingency contemplated by the provision did not occur, and Wyoming Associated did not become a lessee of the State oil land.

b. It has been held that a federal tax upon the net income of a lessee is an unconstitutional interference with the State. The reason for this rule appears to be the fear that the freedom to make leases, or the amount of the royalties received, might be impaired by subjecting the lessee to federal taxation. See *Gillespie* v. *Oklahoma, supra,* 506. This reason has no application to this case. If the income of Wyoming Associated were subject to federal taxation because it was not the lessee of the State lands, but merely the possessor of rights against the lessee, the reasoning of the *Gillespie* case might lead to the conclusion that the freedom of the lessee to dispose of tax-exempt income would be impaired. But this would not affect the State at all except as this inhibition resulted in an unwillingness of oil producers to make leases under these circumstances. The conclusion of the court

below must thus be rested on the following line of reasoning: (1) to tax Wyoming Associated on the income realized under the declaration of trust hampers the lessee in disposing of the income realized from the trust; (2) if the lessee cannot confer tax immunity as well as the income from the lease on the beneficiary of such a trust, the income is of less economic advantage to the lessee; (3) the prospective lessee will accordingly exact more onerous terms from the lessor State; (4) this in turn will interfere with the essential governmental functions of the State; and, finally, (5) each of these possibilities will be so nearly certain and so serious an influence as to compel the conclusion that the Constitution forbids the tax. It needs no elaboration to demonstrate that this chain of hypothetical consequences is wholly speculative and unreal. It follows that there is no reason, in logic or experience, why Wyoming Associated should be exempt from federal taxation. And, as this Court has frequently pointed out, the doctrine of tax immunity is limited by its reason. *National Bank* v. *Commonwealth,* 9 Wall. 353, 362; *Board of Trustees* v. *United States,* 289 U. S. 48, 59; *Helvering* v. *Powers,* 293 U. S. 214, 224–225; *Indian Territory Oil Co.* v. *Board,* 288 U. S. 325, 328; *Metcalf & Eddy* v. *Mitchell,* 269 U. S. 514, 523.

These principles have been applied by the Circuit Court of Appeals for the Sixth Circuit in a closely related situation. In *Hobart Iron Co.* v. *Commissioner,* 83 F. (2d) 25, certiorari denied, 299

U. S. 543, the court held that the sublessee of mineral lands leased by the State of Minnesota was subject to income taxation by the federal government. The court said (p. 26):

> The tax was levied, not upon the property of the state nor upon the income the state derived from its property, but upon the net income of a private corporation derived from the sale of ore which the corporation had acquired under contract with private persons. We think the principles announced in *Burnet* v. *A. T. Jergins Trust* are applicable.

Here Wyoming Associated made no payments to the State, as did the sublessee in the *Hobart Iron* case. It did not operate the property, as did the Hobart Iron Company. There is, accordingly, even less reason to apply the *Gillespie* and *Coronado* rule in the present case, where Wyoming Associated is a complete stranger to the State and where the income from the lease is derived without its aid.

3. This Court has not hitherto decided the precise question here presented. But its decisions in related fields offer instructive parallels.

a. Without questioning the decisions in *Panhandle Oil Co.* v. *Knox,* 277 U. S. 218, and *Indian Motocycle Co.* v. *United States,* 283 U. S. 570, this Court has held that sales to a federal contractor may be taxed by the State, *Trinityfarm Co.* v. *Grosjean,* 291 U. S. 466, and that the Federal Government may tax the transportation of goods shipped by a vendor to a purchasing county of a State, *Wheeler*

Lumber Co. v. *United States,* 281 U. S. 572. The ground of these decisions was that the tax was not laid on the Government itself nor was it laid on the transaction with the Government.

Similarly, without questioning the principle that the State was unable to tax the income of government bonds, this Court held in *Willcuts* v. *Bunn,* 282 U. S. 216, 227, that:

> The sale of the bonds by their owners, after they have been issued by the State or municipality, is a transaction distinct from the contracts made by the government in the bonds themselves, and the profits on such sales are in a different category of income from that of the interest payable on the bonds.

In *Marland* v. *United States,* 3 F. Supp. 611 (C. Cls.), certiorari denied, 290 U. S. 658, and *Rice Oil Co.* v. *United States,* 7 F. Supp. 414 (D. Mont.), the rule of *Willcuts* v. *Bunn* was applied in the case of oil leases from a State which were assigned by the lessees at a profit.

This Court, in sustaining a tax which concededly would result in added costs to the Government, has succinctly phrased the guiding principles in *James* v. *Dravo Contracting Co., supra.* It said (pamphlet p. 10, citations omitted):

> The tax is not laid upon the Government, its property or officers. * * *
>
> The tax is not laid upon an instrumentality of the Government. * * * Re-

> spondent is an independent contractor. The tax is non-discriminatory.

These principles are fully applicable here. Even if the income derived by the Midwest Oil Company from the oil lease be exempt from federal taxation, this exemption from a non-discriminatory tax does not extend to Wyoming Associated, which has no relation, contractual or otherwise, with the State.

The lower federal courts have applied these principles, not only to refuse exemption to the income derived by the sublessee of state lands (*Hobart Iron Co.* v. *Commissioner, supra,* pp. 19–20), but to deny a claim of immunity when raised by the lessee himself. In *Wanless Iron Co.* v. *Commissioner,* 75 F. (2d) 779 (C. C. A. 8th), certiorari denied, 295 U. S. 765, the court held that the royalty paid by a sublessee to the assignee of a lessee of mining lands owned as school lands by the State of Minnesota was not exempt from federal taxation. This was held to result because the subleases (p. 782):

> are distinct, separate contracts, to which the state of Minnesota is not a party, and the tax here is measured by the net income of the taxpayer arising from its operations in a private capacity for private gain. The sublessees agree to pay the petitioner royalties, and it thus obtained a profit from the sublessees' operation of the mines.

Similarly, the lessee of state lands who erects a building and rents office space has several times been held subject to federal taxation on the income so realized. *Helvering* v. *Atlas Life Ins. Co.,* 78

F. (2d) 166 (C. C. A. 10th); *Eckstein* v. *United States,* 10 F. Supp. 231 (C. Cls.), certiorari denied, 296 U. S. 582; *Metropolitan Building Co.* v. *United States,* 12 F. Supp. 537 (C. Cls.), certiorari denied, 297 U. S. 713.

b. The question may be viewed from another angle. In *Jaybird Mining Co.* v. *Weir,* 271 U. S. 609, an *ad valorem* state tax on ores mined under a lease of Indian lands, and held in bins prior to payment of the agreed royalty was held invalid. Yet in *Indian Territory Oil Co.* v. *Board,* 288 U. S. 325, the Court, without questioning the *Jaybird* case, sustained an *ad valorem* tax on oil held in storage by the lessee of Indian lands because the tax was imposed after the payment of the royalties. "Payment had been made for the share of the Indian lessors and they had no further interest in the oil" (288 U. S. at 327). See, also, *Taber* v. *Indian Territory Co.,* 300 U. S. 1, 4–5.

So, too, in this case, Wyoming Associated had a claim to the income from the lease only after the royalties had been paid to the State. Even if it be thought that the Midwest Oil Company, as the lessee, realized its income by operations prior to the payment of the royalty to the State, this does not apply to Wyoming Associated. The lease contemplated that Midwest would (1) extract the oil, (2) deliver 65 per cent. of it to the State, and (3) sell it. Only after these three steps had been taken would Wyoming Associated be paid its share of the benefits and net proceeds. It results that *Indian*

Territory Oil Co. v. *Board* requires that a tax on this income, paid after the State had parted with all interest in the oil, be sustained as one unrelated to the leasing transaction of the State.

4. It is clear that Wyoming Associated was not a state instrumentality and did not derive its income from a transaction with the State. Certainly it cannot be said, to justify this extension of the tax exempt group by the court below, that it has affimatively been shown that the taxation of Wyoming Associated so threatens the independence of the State as to endanger our dual system. But, unless this danger be shown, the special advantage of tax immunity will not be conferred on the private entrepreneur. *Helvering* v. *Powers,* 293 U. S. 214, 224–225; *Metcalf & Eddy* v. *Mitchell,* 269 U. S. 514, 523; *Indian Territory Oil Co.* v. *Board,* 288 U. S. 325, 328; *Willcuts* v. *Bunn,* 282 U. S. 216, 225; *Educational Films Corp.* v. *Ward,* 282 U. S. 379, 391; *National Bank* v. *Commonwealth,* 9 Wall. 353, 362. Correlatively, this Court has been aware of the imperative importance that there be no attrition of the sources of tax revenues. *Willcuts* v. *Bunn,* 282 U. S. 216, 225; *Helvering* v. *Powers,* 293 U. S. 214, 225; *United States* v. *California,* 297 U. S. 175, 184–185; *Susquehanna Co.* v. *State Tax Commission* (*No. 1*), 283 U. S. 291, 294.

Since the rule of the *Gillespie* and *Coronado* cases is not to be applied except in closely analogous circumstances (*supra,* p 14), it seems quite plain that it should not be applied in a case such

as this, where Wyoming Associated was not the lessee of the State lands, had no relation, contractual or otherwise, with the State, and derived its income from the oil development only by virtue of its private arrangement with the lessee.

B. *The Lessee of Government Lands is not Exempt from Taxation on the Income Derived from Them*

It has been shown that the rule of *Gillespie* v. *Oklahoma,* 257 U. S. 501, and *Burnet* v. *Coronado Oil & Gas Co.,* 285 U. S. 393, is not applicable to the facts of this case. It is, therefore, unnecessary to consider whether these cases can be reconciled with subsequent decisions of this Court. If, however, the Court should view the decisions in the *Gillespie* and *Coronado* cases as applicable to the circumstances of this case, it will then be necessary to consider whether or not those decisions are controlling authorities at this time.[3]

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[3] The petition for certiorari (pp. 8–9) in this case, so far as the tax immunity question is concerned, was based upon the propositions (1) that the court below had improperly extended the *Coronado* case, and (2) that there was a substantial conflict with *Bankline Oil Co.* v. *Commissioner*, 90 F. (2d) 899 (C. C. A. 9th), certiorari granted, No. 388, this Term. The memorandum for the Commissioner, not opposing the petition in the *Bankline* case, stated the Government's view that *Burnet* v. *A. T. Jergins Trust*, 288 U. S. 508, was in substantial conflict with the *Gillespie* and *Coronado* cases. There seems, therefore, to be no question but that this question is properly presented to the Court. Compare *Morehead* v. *New York ex rel. Tipaldo*, 298 U. S. 587 604–605.

Since their decision the law of intergovernmental tax immunity has received a considerable development in the decisions of this Court. This development seems to be inconsistent with the result reached in the *Gillespie* and *Coronado* cases, and it is believed that this Court would clarify rather than unsettle the law if at this time it were to reexamine those decisions. The Government accordingly submits: (1) the rule attributed to the *Gillespie* and *Coronado* cases has not been fully accepted by this Court; (2) the postulates upon which those cases rest have since explicitly been rejected by the Court; and (3) the reasons for conferring tax immunity on private persons are absent in the case of a lessee of government lands.

1. This Court has never fully accepted the general rule of the *Gillespie* and *Coronado* cases. This conclusion follows from the course of the decisions relating to the taxation of the income realized from the exploitation of land leased from the government.

The first of the decisions in this field was the *Gillespie* case, decided in 1922. There the State of Oklahoma sought to impose an income tax on the proceeds derived from the operation of an oil lease made by the United States with respect to Indian lands. The parties agreed that the lessee was an instrumentality of the United States (257 U. S. at 504). The Court held that the tax was not saved because it was a net rather than a gross income tax. Then, in 1931, this Court decided *Group No. 1 Oil*

Corp. v. *Bass,* 283 U. S. 279. In that case the Federal Government was held to have constitutional power to tax the net income realized from operations under an oil lease of school lands owned by the State of Texas. The *Coronado* case was decided a year later. There the Federal Government was held unable to tax the income realized from the exploitation of an oil lease of school lands owned by Oklahoma. Finally, in *Burnet* v. *A. T. Jergins Trust,* 288 U. S. 508, the income derived from operations under an oil lease of lands purchased by the city of Long Beach, California, for the purposes of water supply, was in 1933 held subject to federal taxation.

It is difficult to find a consistent course of decision running through these cases. The *Gillespie* and *Coronado* cases seem to be basically indistinguishable from the *Group No. 1* and *Jergins* cases. The ground advanced in the *Group No. 1* case was that, under Texas law, the "grant and lease" was a present sale of the underground oil.[4] In the *Jergins* case, the ground of distinction was that the state lands were not held in trust. Neither distinction seems relevant to the reasons for the rule of intergovernmental tax immunity.[5]

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[4] We have found no evidence that the Texas rule is applied in Wyoming. See Thornton, *Oil and Gas.* Sec. 55 (d) (4th Ed.): *Miller* v. *Buck Creek Oil Co.*, 38 Wyo. 505.

[5] Each distinction, it must be confessed, was urged on this Court by the Government. The Court will note that we do not argue that the *Group No. 1* and *Jergins* cases were wrongly decided, but merely that the acceptance by this

Whether or not an oil lease under state law is technically to be described as a lease or as a sale of the underground oil does not seem sufficient to control the constitutional power to tax the income realized from the lease. Indeed, as a matter of statutory construction, it would be insufficient to control even the application of the Revenue Acts. *Palmer* v. *Bender,* 287 U. S. 551, 555, 556. The reason for the immunity from taxation of income derived from state leases may be viewed as a fear that the State will receive less money for its lease, or as a fear that its freedom to lease will be subject to "interference" if the lessee is taxable. In either case, the taxing power of the Federal Government is just as effective a discouragement to state leases whether they be viewed as a sale of the underground oil or as a privilege to extract it. Accordingly, since "no case has extended * * * immunity to property, real or personal, or income derived from its sale, where it has passed to the buyer by a completely executed act of sale" (*Group No. 1 Oil Corp.* v. *Bass, supra,* 283–284), the two cases extending a similar immunity to the income derived from operations under an oil lease seem incompatible with the *Group No. 1* case. It should be noted that, even where the lease does not effect a present conveyance of the oil in place, the lessee after extracting the oil sells it as his own property.

Court of distinctions which do not go to the heart of the *Gillespie* and *Coronado* rule indicates that this rule is not firmly established.

The *Jergins* case put aside the *Gillespie* and *Coronado* cases on the ground that "in both of those cases the sovereign was acting as the trustee of an express trust with regard to the lands leased" (288 U. S. at 516). But the doctrine of intergovernmental tax immunity rests on the principle that the implications of the Constitution forbid a tax on *any* essential governmental function which threatens the independence of the state or federal government. There seems to be no reason to distinguish lands held in trust for a specific governmental function and those held for governmental functions in general.[6] If the tax on the income of the lessee interferes with a governmental function, it does so as fully in the one case as in the other. In the case of a tax on the income derived from operations under leases from the sovereign of lands held for governmental purposes in general, "its collection is not inconsistent with and does not trench upon the immunity of the state as a sovereign" (288 U. S.

[6] It may be noted that the "trust" which attaches to school lands held by the State is almost indistinguishable from the more or less fiduciary capacity in which all public property is held. In *Cooper* v. *Roberts*, 18 How. 173, the Court said of school land grants (pp. 181–182):

"The trusts created by these compacts relate to a subject certainly of universal interest, but of municipal concern, *over which the power of the State is plenary and exclusive.* In the present instance, the grant is to the State directly *without limitation of its power*, though there is a sacred obligation imposed on its public faith. We think it was competent to Michigan to sell the school reservations without the consent of congress." [Italics added.]

at 516). No more does it trench on a sovereign immunity when the lands are held for a specific governmental purpose.

The *Group No. 1* and *Jergins* cases, while distinguishable in this manner from the *Gillespie* and *Coronado* cases, seem by implication to have disapproved the basic premises of the latter cases. It has been noted (*supra*, p. 14) that the *Gillespie* and *Coronado* cases were decided by a divided Court and have been limited by the Court to closely analogous circumstances. On the other hand, the *Group No. 1* and *Jergins* cases were decided by a unanimous Court, and subsequent opinions have never indicated that their authority is weak.

The decision of the Circuit Court of Appeals for the Eighth Circuit that a lessee of government mining land is taxable on the income which is paid him by his sublessee has been discussed above (*supra*, p. 22). *Wanless Iron Co.* v. *Commissioner*, 75 F. (2d) 779, certiorari denied, 295 U. S. 765. Similarly, the uniform course of decisions in the lower courts is to the effect that a lessee of state lands who erects a building and leases office space is subject to federal taxation on the income so realized. *Eckstein* v. *United States*, 10 F. Supp. 231 (C. Cls.), certiorari denied, 296 U. S. 582; *Metropolitan Building Co.* v. *United States*, 12 F. Supp. 537 (C. Cls.), certiorari denied, 297 U. S. 713; *Helvering* v. *Atlas Life Ins. Co.*, 78 F. (2d) 166 (C. C. A. 10th). It is difficult to distinguish the income which a lessee derives by subleasing and

that which he derives by selling the oil or minerals extracted. If anything, the former would seem to have the more impressive claim for immunity under *Group No. 1 Oil Corp.* v. *Bass, supra.* It hardly seems that the lower courts would have reached these results, or that this Court would have denied certiorari, if the *Gillespie* and *Coronado* rule has the vitality for which respondents contend.

It is respectfully submitted that, if the *Gillespie* and *Coronado* cases were expressly overruled, the administration of the revenue laws both of the Nation and of the States would be simplified, and that the burden of taxes as between persons similarly situated would become both more uniform and more just.

2. This Court has expressly rejected each of the premises advanced in the *Gillespie* and *Coronado* cases to justify the grant of tax immunity to the private operator of an oil lease of government lands.

a. In the *Gillespie* case the Court refused to accept the contention that a net income tax on the lessee produced but a slight or problematic effect upon the lessor State. It put aside the interstate commerce cases [7] on the ground that "the rule as to instrumentalities of the United States on the other hand is absolute in form and at least stricter in

[7] *Peck & Co.* v. *Lowe*, 247 U. S. 165, 175; *U. S. Glue Co.* v. *Oak Creek*, 247 U. S. 321; *Shaffer* v. *Carter*, 252 U. S. 37, 57.

substance" (257 U. S. at 505). But, in *James* v. *Dravo Contracting Co.*, No. 3, October Term, 1937 (pamph. p. 17), this Court has not only rejected but has reversed this rule, and has held that a gross income tax upon the receipts of a government contractor is valid even though such a tax upon receipts derived in interstate commerce would be invalid.

b. The main ground of the decision in the *Gillespie* case was that "a tax upon such profits is a direct hamper upon the efforts of the United States to make the best terms it can for its wards" (257 U. S. at 506). But obviously the taxation would not force the government to accept an offer to lease the lands which would be less attractive than otherwise would be the case except so far as it operated to reduce the amount of the royalty offered. The effect of taxing the lessee was, accordingly, supposed to be reflected in the *price* received by, as opposed to *interference* with, the sovereign. This ground for conferring tax immunity has frequently been rejected in subsequent decisions of this Court. If a net income tax on the lessee lowers the price received by the government, so too it increases the cost to the government when imposed on its contractors. But such a tax is valid. *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514; *General Construction Co.* v. *Fisher*, 295 U. S. 715. A tax on the sale of goods to the government contractor is valid, even though it must operate to increase the cost of the sovereign. *Trinityfarm Co.* v. *Grosjean*, 291 U. S. 466; *Tirrell*

v. *Johnston*, 293 U. S. 533, cf. *Henneford* v. *Silas Mason Co.*, 300 U. S. 577. A tax on the manufacture or transportation increases the cost to the purchasing sovereign, but is nonetheless valid. *Wheeler Lumber Co.* v. *United States*, 281 U. S. 572; *Liggett & Myers Co.* v. *United States*, 299 U. S. 383. Even more certainly is the cost to the sovereign increased by a gross receipts tax on the contractor's income. Yet such taxes are valid. *Alward* v. *Johnson*, 282 U. S. 509; *James* v. *Dravo Contracting Co.*, *supra*. In the latter case the Court expressly recognized (pamph. pp. 18–19) the probability of added cost to the Government. Finally, the language of this Court in the *Group No. 1* case is fully as applicable to this lease as to that which technically was a "sale" of the oil in place. The Court there said (p. 282):

> We may assume that if the property is subject to tax after sale, the governmental seller will generally receive a less favorable price than if it were known in advance that the property in the hands of later owners, or even of the buyer alone, could not be taxed.
>
> But the remote and indirect effects upon the one government of such a non-discriminatory tax by the other have never been considered adequate grounds for thus aiding the one at the expense of the taxing power of the other. * * *

c. In the *Coronado* case, while relying chiefly upon the *Gillespie* case, the Court advanced another

reason for the immunity. It said (285 U. S. at 400–401):

> Here the lease to the respondent was an instrumentality of the State for the purpose of carrying out her duty in respect of public schools. To tax the income of the lessee arising therefrom would amount to an imposition upon the lease itself.

But since that decision this Court has expressly disapproved the proposition that a tax on the income is a tax on the source. In *New York ex rel. Cohn* v. *Graves,* 300 U. S. 308, the Court sustained a New York tax on the income derived by its resident from New Jersey real estate. This was because "income is not necessarily clothed with the tax immunity enjoyed by its source" (p. 313). And in *James* v. *Dravo Contracting Co., supra,* the Court sustained a tax on the *gross* income of a government contract, expressly stating (pamph. p. 10) that "the tax is not laid upon the contract of the Government."

d. Although not explicitly advanced, it might be thought that the *Gillespie* and *Coronado* cases rest on a general principle that income derived by virtue of a government license, or from government property, is exempt, irrespective of any actual cost or ascertainable interference with the government. *Fox Film Corp.* v. *Doyal,* 286 U. S. 123, sustaining a state tax on income realized under a copyright, is a sufficient answer to the first suggestion. And since the oil, from the moment it is extracted, is no

longer the property of the State, this case differs in no manner from the usual case of resale of property purchased from the government. Income derived on such a resale, of course, is not tax exempt. *Group No. 1 Oil Corp.* v. *Bass, supra,* 282.

No other reason advanced by the Court as the ground for the decisions in the *Gillespie* and *Coronado* cases has been discovered. Each of the premises relied on in those cases has expressly been rejected by subsequent decisions of this Court.

Moreover, the rule of the *Gillespie* and *Coronado* cases seems directly contrary to the decision in *Indian Territory Oil Co.* v. *Board,* 288 U. S. 325. There this Court sustained an *ad valorem* tax on oil, extracted under a lease of Indian lands, which was stored after payment of the agreed royalties. It said (p. 328):

> Such immunity as petitioner enjoyed as a governmental instrumentality inhered in its operations as such, and being for the protection of the Government in its function extended no farther than was necessary for that purpose. **The holding of the oil in question, which had been segregated and withdrawn from the restricted lands as petitioner's exclusive property, awaiting disposition at petitioner's pleasure, was for its sole advantage and cannot be said to be so identified with its operations as a governmental instrumentality as to entitle it to exemption from the general property taxes imposed by the State in return for the protection the State afforded.** * * *

At least where, as in this case, the royalties are paid in kind, a precisely comparable situation is present in the case of the income tax. The lessee first extracts the oil. At the mouth of the well he delivers the oil to the lessor. The remaining oil is his absolute property. Under the *Indian Territory* case, he is subject to a property tax on this oil. No reason is apparent why he should not also be subject to an income tax.[8]

If there were any doubt that this rule is equally applicable to an income as to a property tax, it would be removed by the decision of this Court in *Peck & Co.* v. *Lowe,* 247 U. S. 165. There the express constitutional prohibition against a tax "on articles exported from any State" (Art. I, Sec. 9, cl. 5) was held inapplicable to a tax on the income derived from export sales.[9] This Court said (pp. 174–175) of the income tax there in question:

> It is not laid on income from exportation because of its source, or in a discriminative way, but just as it is laid on other income. The words of the act are "net income arising or accruing from all sources." There is no

[8] It is true that the deductions from gross income reach back into the period prior to the payment of the royalty. But it is not the deductions, allowed as a matter of grace, but the income which is taxed; this is realized only after payment of the royalties.

[9] The decision in *Liggett & Myers Co.* v. *United States,* 299 U. S. 383, relying on *Cornell* v. *Coyne,* 192 U. S. 418, shows that taxation permitted under clause 5 of Section 9 of Article I is equally permitted under the implied prohibition against intergovernmental taxation.

> discrimination. At most, exportation is affected only indirectly and remotely. The tax is levied after exportation is completed, after all expenses are paid and losses adjusted, and after the recipient of the income is free to use it as he chooses. * * *

3. It is unnecessary to dwell upon the fact that maintenance of tax revenues is a matter of imperative importance both to the States and the Nation (*supra*, p. 24). Similarly, it is unnecessary to elaborate the unfortunate consequences which flow from a division of private competitors into taxable and tax-exempt classes; there inevitably develop conditions of special advantage, dissatisfaction, and general lack of confidence in the equity of taxing systems. It is for these reasons that this Court has so often announced that it would hold unconstitutional only those taxes which contain a real and substantial threat to the maintenance of that independence of the States or the Nation which is essential to our dual system of government.[10]

The power to tax the income realized by the lessee of government lands in no sense contains a threat to this necessary independence of the nation and the states. The government lessor remains

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[10] *Helvering* v. *Powers*, 293 U. S. 214, 225; *South Carolina* v. *United States*, 199 U. S. 437; *Ohio* v. *Helvering*, 292 U. S. 360, 368–369; *Board of Trustees* v. *United States*, 289 U. S. 48, 59; *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 523; *Indian Territory Oil Co.* v. *Board*, 288 U. S. 325, 328; *Willcuts* v. *Bunn*, 282 U. S. 216, 225; *Educational Films Corp.* v. *Ward*, 282 U. S. 379, 391; *National Bank* v. *Commonwealth*, 9 Wall. 353, 362.

wholly free to lease or not, as it chooses. It may prescribe the terms of the lease with the same freedom which it otherwise would have. It may, as fully as though the lessee were tax exempt, use the proceeds for whatever purpose it desires.

The only possible effect upon the government lessor is that the sovereign would lose an advantage now possessed, in that oil and mineral operators would no longer be more anxious to lease from the government than from a private lessor. This is a very doubtful conclusion. The overwhelming consideration in such leases, typically, may be supposd to be the gamble as to the quantity and ease of extraction of the oil or mineral which is in place underground. If the development is successful, the profits usually will be larger than in the ordinary business enterprise. It seems most unlikely that the typical lessee would substantially reduce the terms he offers the government lessor if he knew that his net income would be subject to taxation. His decisions are shaped by geologic rather than cost accounting estimates.

But even if it be assumed that occasionally or even generally the government lessor would receive a somewhat larger royalty if the lessee were exempt from an income tax on his profits from the lease, this in no sense invalidates the tax. The independence of the government does not require that it receive a *special* advantage in the market place. A non-discriminatory tax upon the income of lessees of mineral lands, even though it were to reduce

somewhat the revenues of the government lessors, is wholly irrelevant to the governmental functions either of the States or the Nation. If this Court were so to hold, it is submitted that its decisions would be made more consistent, that the doctrine of intergovernmental tax immunity would be brought more nearly into line with its reasons, that the revenues of the central and the local governments would be augmented, and that the undesirable and special privilege of tax immunity now extended to certain of the competing oil and mineral operators would be eliminated.

II

THE CASH PAYMENTS RECEIVED BY RESPONDENT'S AFFILIATE FOR OIL AND GAS PRODUCED CONSTITUTE THE "GROSS INCOME FROM THE PROPERTY" ON WHICH ITS PERCENTAGE DEPLETION SHOULD BE COMPUTED

In the present case Wyoming Associated, the respondent's affiliate, has been allowed a depletion allowance on its gross income received from the property in the form of the cash payments received for oil sold to the Refining Company. The question for determination is whether computation of Wyoming Associated's gross income from the property for depletion should also include the amount of the development and production expenses paid by the Refining Company.

Section 234 (a) (8), Revenue Act of 1926 (Appendix, p. 57), provides that in computing net income corporations may deduct a reasonable allowance for depletion of oil and gas wells. Section

204 (c) (2) (Appendix, p. 56), provides that this allowance shall be "27½ per centum of the gross income from the property" during the taxable year, provided (1) that the allowance shall not exceed "50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property", and (2) that the allowance shall not be less than it would be if computed without reference to this paragraph.

The Commissioner of Internal Revenue and the Board of Tax Appeals treated the total cash payments of $4,606,535.70 paid to the seller of the oil, Wyoming Associated, by the purchaser, the Refining Company, as the "gross income from the property" of Wyoming Associated for the computation of its 27½% depletion allowance (R. 41).

The respondent contended before the Board of Tax Appeals that the gross income for percentage depletion should be considered to be the market value of the oil or, in the alternative, the sum of the aforesaid cash payments plus the field operating expenses of the Refining Company stipulated to be $2,816,520.04 (R. 38, 145). In the court below the respondent elected to rely upon the second alternative and the court allowed percentage depletion on this basis (R. 153–155). Before the Board the respondent also relied on depletion based on cost in lieu of percentage depletion (R. 22, 32, 45) and since the Board reduced the deficiency to some extent the respondent evidently was allowed cost depletion where it exceeded percentage depletion com-

puted without reference to the Refining Company's production expenses.

The Government contends that the cash price received for oil is the seller's entire "gross income from the property" for percentage depletion where, as here, the oil is produced and purchased under contracts whereby the purchaser, the Refining Company, agrees to conduct and to pay the expense of development and production operations and to pay a cash price for all oil produced which is based on prices it obtains for gasoline and kerosene sold at its refinery. The Government contends that under this contractual arrangement (A) the Refining Company's production operations are not gross income of Wyoming Associated; (B) even if any value of the operations to Wyoming Associated is its gross income, the actual expenses of the Refining Company is not the measure of that value to Wyoming Associated; and (C) the respondent's contention denies the Refining Company any depletable interest in the oil.

A. *The Refining Company's production operations are not gross income of Wyoming Associated*

1. The Government contends that the production operations performed by the Refining Company for its own benefit are not gross income of Wyoming Associated. There may be some circumstances in which services rendered on behalf of and for the separate use of a taxpayer may be considered to

have a value to him which can be expressed in terms of money and which can be considered to increase his gross income at the time he receives the services. For example, one who pays cash for a physician's services does not realize income from the transaction, but one who exchanges a share of stock for such services may realize income based on the difference between the cost or other basis of the stock and the value of the services to him, which might be the market price of the stock. In other circumstances, however, one may receive something of value in the form of property which, under one view at least, might be considered to be income at the time some disposition of it is made, but not at the time it is received. An illustration is the question whether a lessor receives income when a lessee places a building on the real estate or not until the property is sold or the lease expires. Cf. *Hewitt* v. *Commissioner,* 76 F. (2d) 880 (C. C. A. 2d, Chase, J.; L. Hand, and Swan, J. J., concurring in a separate opinion). It is submitted, however, that where, as in the present case, oil production operations are conducted by a purchaser ***for his own benefit*** in order to obtain the oil at a contract price which he may deem favorable, those operations are not income of the seller of the oil. They are not "something of exchangeable value * * * ***received*** or ***drawn by*** the recipient (the taxpayer) for his ***separate*** use, benefit, and disposal—***that*** is income derived from property." (Italics by the Court.) *Eisner* v. *Macomber,* 252 U. S. 189, 207.

Wyoming Associated evidently accepted this view because it did not include the production expenses in its gross income on its books or in the income tax return (R. 37).

2. The respondent argued in its brief in the court below that the Refining Company paid something in addition to the cash price for the oil because the cash contract prices were less than the market price happened to be when the oil was produced. This argument does not support the respondent's contention, even if there was a difference between market and contract price in a particular year, because when the contracts were made for a period of approximately eleven years from February 1, 1923, to January 1, 1934, the parties could not determine a contract price based on possible future market prices and production expenses. They could not have intended that the Refining Company should pay something for the oil in addition to the cash price on the basis of unknown future market prices and production expenses.

Moreover, the contract price was expressly related to a basis other than market price and might be greater than market price. The assumption that there would necessarily be a difference between market and contract price of the oil under these contracts is erroneous. The method of determining the cash purchase price for oil provided in the contracts does not refer and is not related to the field market price of oil. The contract price is not fixed at less than market price so

that it may be said that Wyoming Associated was being paid cash and services equal to the market price.

The cash contract price was based on a sliding scale depending on the current monthly price obtained by the Refining Company for gasoline and kerosene sold from its refinery at Casper, Wyoming (R. 114). This scale of cash prices did not insure that the Refining Company would always pay less than market price for the oil. There is no fixed margin between the prices of crude oil and gasoline and kerosene.[11] Situations might have arisen in which the Refining Company would have paid in cash more than the market price of the oil. Both parties gambled on the future relation between the market prices of oil and those of gasoline and kerosene.

The Refining Company was obliged to conduct the production operations under the contracts. Wyoming Associated also assumed obligations under the contracts. The Refining Company had the right to use, free of charge, all of the storage facilities, building equipment, and pipe lines of Wyo-

[11] There have been periods when the price of crude oil dropped to a few cents a barrel and the average price of gasoline dropped only a few cents a gallon. For example, when the price of crude oil fell to extremely low levels between January and August 1931, the average retail price of gasoline to the consumer dropped only 2.35 cents; the drop in retail prices during the collapse of crude oil prices in 1933 was only 1.72 cents. See Oil and Gas Journal, January 25, 1934, p. 42.

ming Associated on the property (R. 114–115). The Refining Company was entitled to use, free of charge, so much of the oil and gas produced as was reasonably necessary for drilling, domestic service, and production (R. 115). These factors must have been considered in fixing the cash price paid for the oil. It is impossible as a practical matter to construct a theoretical price which would give effect to all of the factors which probably influenced the parties in fixing the contract price. In these circumstances a "gross income" for depletion should not be constructed artificially by adding some amount to the cash contract price received as gross income.

The production operations were promised and rendered by the Refining Company, not as part of the purchase price of the oil, but for its own benefit and in consideration for the promise of Wyoming Associated to permit the Refining Company to produce the oil and to purchase it at a price which bore a relation to the purchaser's gasoline and kerosene prices. This is made apparent by the fact that if drilling had been unsuccessful and if no oil had been produced the services could not have been considered as part of the purchase price for oil, but would be paid for by the promise to sell oil produced at a fixed price. This is the meaning of the contracts as performed by the parties even though they recite that "as part of the price of oil purchased" (R. 115, 120) the production opera-

tions are to be conducted by the Refining Company. These recitals alone cannot make the production operations Wyoming Associated's gross income if in fact they were performed for the Refining Company's benefit and not for Wyoming Associated's "*separate* use, benefit, and disposal, * * *." *Eisner* v. *Macomber, supra.*

3. The court below relied on the consideration it expressed to the effect that if Wyoming Associated had produced the oil at its own expense its gross income would have been the price of the oil, including in cash the amount representing the cost of production, and, therefore, the same result should be reached where the purchaser produces the oil (R. 154). The premise is not correct because it could not be certain that either a market or a contract price for oil produced by the seller would even repay operation expenses. Perhaps the avoidance of that risk and speculation is the reason the seller entered this contract.

Moreover, there is no weight, for tax purposes, in the argument that the same result should be reached as if Wyoming Associated had engaged in the business of producing oil. Wyoming Associated chose not to engage in the oil producing business and preferred the business of allowing the purchaser to engage in the risks of production. The different types of business produce different gross incomes from the property. This is true generally of any taxpayer who owns raw material

and chooses to permit a purchaser to prepare it for the market rather than to engage in that business himself. The seller cannot artificially construct his gross income as if he had engaged in the purchaser's business. "To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty." *Founders General* v. *Hoey,* 300 U. S. 268, 275.

The sole authority cited by the court below on this point, *Boulton* v. *Heiner,* 3 F. Supp. 372 (W. D. Pa.), is distinguishable, we believe. The court held that the cost basis of stock included not only the cash paid but also services as incorporator rendered for the stock. That decision does not support the view that oil production operations by a purchaser rendered for his own benefit are gross income of the seller for his separate use.

An owner of oil, or any other commodity, instead of preparing the product for delivery and sale, may prefer to charge a lower cash price and to permit the purchaser to undertake the work and expense of preparing the product and making delivery. It would not be said that the seller's price is the cash price plus the value of the services to him. The common, and correct, view is that the seller has lessened his work, lowered his price, and decreased his gross income. The purchaser's processing operations are work for his own benefit, and not work

which is a source of income to the seller in a sum greater than the cash price. The services are not a part of the sale price. The contrary view that the services are part of the sale price and, in effect, that the price has not been reduced, is at a variance with the common understanding that the price is lowered and is an artificial and impractical view of gross income.

4. The arguments stated *supra* in support of the contention that the production operations are not gross income of Wyoming Associated also support the view that these operations are not its "gross income from the property" within the meaning of Section 204 (c) (2) of the Revenue Act of 1926. Cf. *Crews* v. *Commissioner,* 89 F. (2d) 412 (C. C. A. 10th).

This Court has also held that the phrase "gross income from the property" means gross income from the oil and gas[12] *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, 321. See also *Brea Cannon Oil Co.* v. *Commissioner,* 77 F. (2d) 67 (C. C. A. 9th), certiorari denied, 296 U. S. 604; *Consumers Natural Gas Co.* v. *Commissioner,* 78 F. (2d) 161 (C. C. A. 2d), certiorari denied, 296 U. S. 634; *Greensboro Gas Co.* v. *Commissioner,* 79 F. (2d) 701 (C. C. A. 3d), certiorari denied, 296 U. S. 639;

[12] Bonuses are regarded as income from oil and gas in the form of advanced royalties. *Herring* v. *Commissioner,* 293 U. S. 322. The allowance of depletion with respect to such payments is based on that theory.

Article 221, Regulations 69, *infra*. It does not even include cash payments received from the sale of leases of oil properties. *Darby-Lynde Co.* v. *Alexander,* 51 F. (2d) 56 (C. C. A. 10th), certiorari denied, 284 U. S. 666; *Commissioner* v. *Fleming,* 82 F. (2d) 328 (C. C. A. 5th).

In *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, the Court rejected a sublessee's contention that all the gross income which it actually received, and reported in its return as such, was its "gross income from the property" to the extent of royalties it was obliged to and did pay over to its lessor. The Court stated (at page 321):

> We think Congress did not intend a different result where, as here, the lessee sells all the oil and pays over the royalty in the form of cash.

It is submitted that in a case like the present, Congress did not intend that in addition to the contract price some value to the seller, to be placed on production operations by a purchaser, should be included in the seller's gross income from the property. The statute does not require and it was not intended that gross income from the property should be computed in this manner.

The percentage depletion deduction is an arbitrary amount allowed as a matter of grace in place of cost depletion at the taxpayers' option. To succeed the taxpayer must bring his case clearly within the statute. The doubts in this case must be resolved against the taxpayer.

5. The fact that the production operations, performed by the Refining Company for its own benefit, may have been some benefit to Wyoming Associated does not make the operations additional gross income from the property of Wyoming Associated. The extent of the benefit is the cash price received for the oil. The production operations of a lessee are a benefit to the lessor to the extent of the royalties paid in cash or oil in such a case as *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312. But it is not supposed that the lessor could claim the lessee's production operations as depletable gross income in addition to royalties.

The fact that the purchaser under a contract may have no depletable interest is no reason to increase the gross income actually received by the seller by the production expenses of the purchaser.

6. Finally, the Court answered the contention that the statute may work unequal results when it concluded its opinion in the *Twin Bell* case with the following statement (p. 321):

> The respondent insists that, so applied, the section may work unjust and unequal results, but it is to be remarked that this is likely to be wherever a rule of thumb is applied without a detailed examination of the facts affecting each taxpayer. No doubt, as the petitioner points out, equally illogical results might ensue from the application of the statute as the respondent construes it. And it is also to be remembered that depletion upon cost on March 1,

1913, value is optional with the taxpayer, if that procedure is more favorable to him.

It is submitted that in the present case the statute should not be construed to give the seller of oil in the circumstances of this case a gross income in addition to the cash price received for the oil by placing a value to the seller on the production operations of the purchaser. Depletion should be based on the cash price for the oil, or cost or March 1, 1913 value, at the taxpayer's option.

B. *Even if some value of the production operations to Wyoming Associated is included in its gross income, the total production expenses are not the correct measure of that value*

The field operating expenses in the sum of $2,816,520.04 (R. 145) do not supply a correct measure of any value the production operations may have to Wyoming Associated. It does not appear that all of the production operations contributed to the oil produced and sold. A large part of the operations and a large part of the expenses may have been used on dry wells producing no oil and may have been of no value to anyone. The less expensive operations may have produced and may measure the value of all of the oil.

Furthermore, under the contracts the operations were conducted for the benefit of the Refining Company as well as for the benefit of Wyoming Associated. The entire expenditures cannot be taken as the measure of the value of the production opera-

tions to Wyoming Associated without allocation of part of the expenditures to the value of the production operations to the Refining Company which may have obtained oil at a very favorable price.

These considerations disclose the difficulty of attempting to create a theoretical gross income from the property by the evaluation of production operations. It is submitted that the statute was not intended and should not be construed to cover such a situation. In this situation, the depletion allowance of Wyoming Associated must be based either on the cash price received for the oil or on cost of the oil property. *Helvering* v. *Twin Bell Syndicate, supra.*

C. *The Respondent's Contention Leaves No Depletable Interest to the Refining Company*

The Government contends that the "gross income from the property" does not include the value of the production operations and does not contend that the Refining Company has a depletable interest in the oil represented by production expenses or any other sum. It may be noted, however, that the acceptance of the respondent's contention would bar the purchaser from a depletable interest.

It is the Government's basic contention expressed in the three cases to be argued immediately before this case [18] that only owners of oil and gas, *as pro-*

[18] No. 387 (*Helvering* v. *Bankline Oil Co.*); No. 406 (*Helvering* v. *O'Donnell*); No. 446 (*Helvering* v. *Elbe Oil Land Development Co.*).

duced, have such an ownership of, or interest in, the mineral in place as to entitle them to depletion. Cf. Government's brief, p. 7, in No. 387 (*Helvering* v. *Bankline Oil Co.*).

A purchaser of oil or gas under a contractual arrangement, unlike a lessee, has no such ownership or interest and, therefore, is not entitled to depletion. In *Signal Gasoline Corp.* v. *Commissioner,* 66 F. (2d) 886 (C. C. A. 9th) however, the Court held that the purchaser of wet gas, under a contract for which a valuable consideration was paid and in which the purchaser agreed to assist, and thereafter did assist, in the production of wet gas by installation and operation of machinery for that purpose at great expense, did have a right to share in the wet gas produced and a depletable interest which might be proved. On a second appeal, 77 F. (2d) 728, certiorari denied, 296 U. S. 657, the Court stated that the difference between the market value and contract price of wet gas was the purchaser's depletable interest and that the purchaser had failed to prove any such difference.

The Government believes that the theory of the Court's decision in the *Signal* case that market price of oil may determine gross income from oil or gas sold at a contract price is erroneous and is clearly a misapplication of the principles announced by this Court. *Palmer* v. *Bender,* 287 U. S. 555, and *Helvering* v. *Twin Bell Oil Syndi-*

cate, 293 U. S. 312. The market price of the oil in the present case, which was not in fact received for the oil, could not be considered, as the respondent has contended, as a basis for depletion of the Refining Company. Its only possible basis for depletion, if any, would be a part of the oil considered to be obtained in exchange for the production operations.

Apart, however, from the erroneous views, we believe, with respect to the application of market price expressed by the court in the *Signal* case, the first opinion does recognize that a contract whereby a purchaser of gas obtains the right to occupy the land and to conduct production operations, and who pays the producing expenses, may obtain a depletable interest as well as the lessee and seller of the oil.

The Government does not contend that such a contract, distinguished from the contracts involved in No. 387, October Term, 1937 (*Helvering* v. *Bankline Oil Co.*), at page 11 of the Government's brief in that case, may in some cases give the purchaser a depletable interest in oil as produced, whether he sells it at a market or contract price. But if the Court thinks such a "purchaser-producer" contract might give the purchaser a depletable interest it is to be noted that the respondent's contention would deprive the purchaser of any depletable interest.

CONCLUSION

It is submitted that the judgment of the Circuit Court of Appeals is erroneous and should be reversed upon both of the issues presented.

Respectfully submitted.

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JANUARY 1938.

APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 204. * * *

(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 213. For the purposes of this title, except as otherwise provided in section 233—

(a) The term "gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political sub-

division thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period.

* * * * *

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * *

Treasury Regulations 69, promulgated under the Revenue Act of 1926:

> ART. 217. *Depletion and depreciation accounts on books.*—Every taxpayer claiming and making a deduction for depletion and depreciation of mineral property shall keep accurate accounts in which shall be charged the cost or the fair market value as of the basic date, as the case may be, of the mineral deposit and of the plant and equipment, together with subsequent allowable capital additions to each account.
>
> When the plan or method of depletion and depreciation accounting adopted by the taxpayer has once been approved by the Commissioner, it can not be changed by the taxpayer without the consent of the Commissioner. These accounts shall thereafter be credited annually with the amounts of the depletion and depreciation sustained; or the amounts of the depletion and depreciation sustained shall be credited to depletion and depreciation reserve accounts, to the end that when the sum of the credits for depletion and depreciation equals the value or cost of the property, plus subsequent allowable capital additions, no further deductions for depletion and depreciation with respect to the property shall be allowed. See, however, section 204 (c) (2) and article 221 as to oil and gas wells.
>
> ART. 221. *Depletion in the case of oil and gas wells.*—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property.

In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, "the property," as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer.

ART. 223. *Charges to capital and to expense in the case of oil and gas wells.*—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under the provisions of this article will control the taxpayer's returns for all subsequent years. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice

has been carried should accompany the return.

ART. 225. *Depreciation of improvements in the case of oil and gas wells.*—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161–170.)

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1937.

No. 600.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

v.

MOUNTAIN PRODUCERS CORPORATION.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

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IN THE

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No. 600.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

Opinions Below.

The majority and dissenting opinions of the Circuit Court of Appeals for the Tenth Circuit (R., 199) are reported in 92 F. (2d) 78.

Jurisdiction.

Jurisdiction of this Court to entertain petition for certiorari is correctly noted in the petition.

Questions Presented.

1. The interest of respondent's affiliate (The Wyoming Associated Oil Corporation, hereinafter called Wyoming Associated) in an oil and gas lease from the State of

Wyoming, covering school lands, is evidenced by a declaration of trust executed by the lessee named in the lease prior to the issuance of the lease itself. Is income which Wyoming Associated received from this lease exempt from Federal income tax?

2. The purchaser, under written contract with Wyoming Associated, of all the oil produced during specified years from oil lands of Wyoming Associated (not restricted to the State lease noted above), in addition to paying per barrel cash sums, agreed "as part of the price for oil purchased" to perform at its own expense on the lands in question all acts of production and development specified in the contract. Is the *value* of the production and development services so rendered a part of the gross income of Wyoming Associated for the purposes of percentage depletion?[1]

Statutes and Other Authorities Involved.

The statutes and other authorities involved are set forth in the Appendix, pages 14 and 15.

Statement.

Wishing to make our brief as short as possible, we attempt no separate summary of the facts, but refer this Court to the summary set forth in the majority opinion below (R., 200).

---

[1] In the petition the Solicitor General states this question in terms of whether purchaser's expenses are gross income to the taxpayer. In the true sense it is not the purchaser's expenses, as such, which were added to the the taxpayer's gross income; what was really added was *the value of the services*, the stipulated cost of performing the services being used by the lower court merely as the best evidence for measuring the value of the services.

Argument.

The petition for certiorari should be denied, and this Court should not review either of the issues involved.

Issue I.

THE COURT BELOW DID NOT ERR IN HOLDING THAT THE INCOME RECEIVED BY WYOMING ASSOCIATED FROM THE STATE SCHOOL LEASE WAS EXEMPT FROM INCOME TAX; NOR IS ITS DECISION ON THIS POINT IN CONFLICT WITH ANY OTHER DECISION.

The court below held that the principle of *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393, rules the present case. From the agreed facts summarized and condensed in the opinion of the court below, it is apparent that in the instant case (a) the character of the land from which the income was obtained, (b) the source of the State's title thereto (a grant from the United States for school purposes made when the State was admitted to the Union), and (c) the nature of the express trust "for the exclusive benefit of the public schools * * * forever inviolate and undiminished",[1] under which the land and all income accruing to the State therefrom are held, are all identical with the corresponding elements in the *Coronado* case. In the *Coronado* case this Court has recognized tax exemption as applying to the income of a corporate lessee recovering oil from such land, the lease being an instrumentality of the State in performing this sovereign trust obligation.

Even though this doctrine be applied "strictly and only in circumstances closely analogous to"[2] those under which the doctrine originated, it was no extension of the doctrine to apply it to this case. The dissenting opinion in the court

[1] Sec. 6, Art. VII, Constitution of the State of Wyoming accepting United States land grant.

[2] *Burnet* v. *A. T. Jergins Trust*, 288 U. S. 508, 516.